

## Internal Revenue Service

Number: **201636034**  
Release Date: 9/2/2016

Index Number: 1033.01-00, 1033.03-00

Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:  
CC:ITA:B04  
PLR-140107-15

Date:  
June 02, 2016

## LEGEND

Taxpayer =  
City =  
State =  
Year 1 =

Dear

This responds to your request for a private letter ruling, dated December 9, 2015, regarding the application of §1033 of the Internal Revenue Code to your transaction. You request a ruling that the proposed water reclamation facility improvements are “similar or related in service or use” to the condemned City potable water facility under § 1033(a)(2) of the Code.

## FACTS

Taxpayer is a water resource management company that owns and operates integrated potable water, wastewater and reclaimed/recycled water utilities through various wholly-owned subsidiaries (disregarded entities) in State.<sup>1</sup> In Year 1, one of Taxpayer’s potable water utilities was condemned by City.

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<sup>1</sup> The subsidiaries mentioned are corporations that will be reorganized as single-member limited liability companies (LLCs) to make Taxpayer the successor entity as provided under § 381(c)(13) of the Code and § 1.381(c)(13)-1 of the Income Tax Regulations. These reorganizations are not the subject of this ruling request.

The assets that were the subject of the condemnation include both real and personal property. Pursuant to a final judgment of condemnation, Taxpayer received cash compensation and other consideration. Taxpayer proposes to elect to defer the gain from the condemnation by reinvesting the condemnation proceeds in improvements of water reclamation facilities and potable water facilities that it already owns. Taxpayer seeks a ruling that the proposed water reclamation facility improvements are similar or related in service or use to the condemned property. Taxpayer will make these capital improvements within the statutory replacement periods provided under § 1033 of the Code.

While each type of facility has its own processes in treating water and distributing it to users for its intended purposes, Taxpayer's potable water and water reclamation facilities are similar. Specifically, each facility is part of an integrated system in a cycle of water management, treatment and distribution. In both types of facilities, the assets perform the general functions of water intake to the facilities, water treatment and water distribution to customers. The same general classes of assets are utilized at each type of facility.<sup>2</sup>

In addition, Taxpayer's general business and management functions are integrated and shared for both types of facilities, including automation and technology, repairs and maintenance, marketing to the same customer base, and compliance with the same regulatory governance.

## LAW AND ANALYSIS

Section 1033(a)(2) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money and if the taxpayer during the period specified in § 1033(a)(2)(B), for the purpose of replacing the property converted, purchases other property similar or related in service or use to the property converted, then, at the election of the taxpayer, gain on the conversion is recognized only to the extent that the amount realized exceeds the cost of the property intended to replace the converted property.

Rev. Rul. 64-237, 1964-2 C.B. 319 holds, with respect to owner-users of converted property, replacement property is similar or related in service or use if the "physical

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<sup>2</sup> Of course there are some differences. For example, the useful life of certain assets in the water reclamation facility is reduced due to the more corrosive and degrading nature of wastewater compared to the water treated at a potable water facility. Also, while each type of facility uses similar methods of intake and distribution into and out of the respective facility, the actual assets to effectuate these processes are distinct. For example, the water reclamation facility utilizes sewer mains to receive water for treatment while the potable water facility uses intakes and water mains from natural surface and groundwater sources.

characteristics and end uses of the converted and replacement properties are closely similar.” One example given in Rev. Rul. 64-237 of dissimilar end uses is that of an owner that “operates a light manufacturing plant on the converted property and then operates a wholesale grocery warehouse on the replacement property.” The revenue ruling also states that by “changing his end use he has so changed the nature of his relationship to the property as to be outside the nonrecognition of gain provisions.”

Subsequent court holdings have variously described the similar or related in service or use standard as requiring reinvestment -- (1) “in property used in substantially the same business,” *Wheeler v. Commissioner*, 58 T.C. 459, 463 (1972); and (2) that is a “reasonably similar continuation of the petitioner’s prior commitment of capital and not a departure from it,” *Johnson v. Commissioner*, 43 T.C. 736, 741 (1965). It is also recognized that replacement property need not duplicate exactly the converted property (*cf.*, *Loco Realty Co. v. Commissioner*, 306 F.2d 207, 211 (8<sup>th</sup> Cir. 1962), *rev’g* 35 T.C. 1059 (1961) (pertaining specifically to an owner-investor rather than an owner-user of property, yet still applicable to all § 1033 replacements on this principle)).

In addition, with respect to end uses, there are several instances in which the Service has permitted improvements to land already owned by the taxpayer to constitute replacement property. Rev. Rul. 271, 1953-2 C.B. 236 (using conversion proceeds to pay for improvements to retained farmland); Rev. Rul. 60-69, 1960-1 C.B. 294 (improvements to remaining property to prevent repeat of conversion); Rev. Rul. 67-254, 1967-2 C.B. 269 (repairs and rearrangement of taxpayer’s remaining property restoring lost capacity); Rev. Rul. 70-265, 1970-1 C.B. 170 (filling of submerged land to replace condemned land).

In *Maloof v. Commissioner*, 65 T.C. 263 (1975), the petitioner operated an import-export business in China. The assets of the business consisted mostly of inventory in textile products that were manufactured by outside producers. At the outset of the Second World War, petitioner’s business was confiscated by the Japanese. Years after the war, the petitioner recovered on a claim for the loss and realized gain for the lost inventory. The amount recovered was reinvested largely in fixed assets, including land, a building, and machinery, in addition to some inventory. The petitioner used the proceeds to establish a manufacturing business to produce the same sort of goods which, before the war, were produced by outside contractors. The court determined that the proceeds for the converted inventory were reinvested in property similar or related in service or use to the extent of reinvestment in new inventory only. The reinvestment in fixed assets did not qualify. According to the court,

the statute requires a ‘reasonably similar continuation of the petitioner’s prior commitment of capital and not a departure from it.’ While it is not necessary to acquire property which duplicates exactly that which was converted, the fortuitous circumstance of involuntary conversion does not

permit a taxpayer to change the character of his investment without tax consequences. [Citations omitted.]

*Malloof*, at 269. While acknowledging that § 1033 is entitled to liberal and realistic construction, “still the taxpayer may claim its protection only if it does not materially alter his type of business.” *Id.* at 270.

Rev. Rul. 73-225, 1973-1 C.B. 32, gives an example of when a non-identical replacement is similar or related for purposes of qualifying for deferral under § 1033. It concerns a manufacturer who replaces a “manufacturing process facility composed of separate and identifiable process elements” with an improved and changed manufacturing process facility that eliminates, changes, or replaces older technologically obsolete process elements. While both facilities produced the same finished product, the new facility was expected to produce an improved version of that product. The ruling additionally states that while the new facility performs the same manufacturing processes as the old facility, it is not the same as the old facility on a machine for machine basis. In finding that the two facilities were similar or related in service or use, the ruling states that the end use of the property had not been changed, nor had the nature of the relationship of the taxpayer to the property changed.

#### Application of the Functional Use Test.

In this case, Taxpayer was the owner-user of the condemned City potable water facility and will be the owner-user of the water reclamation facilities on which it will add or build water reclamation facility improvements. As the owner-user, for its replacement property to be similar or related in service or use to the converted property, both the physical characteristics and the end uses of the two facilities must be closely similar. In determining whether the condemned potable water facility and the water reclamation facilities have closely similar physical characteristics and end uses, *Loco Realty* and Rev. Rul. 73-225 make clear that the replacement property need not exactly duplicate the converted property.

##### a. Closely Similar Physical Characteristics.

In regards to determining whether the potable water facility and the water reclamation facilities have closely similar physical characteristics, it is necessary to compare the physical equipment and assets in each type of facility. In each type of facility, the equipment and assets effectuate the same basic processes of water intake to the facilities, water treatment and water distribution to customers.

While the equipment and assets utilized at the condemned City potable water facility and in the water reclamation facilities on which the water reclamation facility improvements are to be constructed are not identical or duplicative, they are substantially similar.

As in Rev. Rul. 73-225, while the two types of facilities (potable and reclaimed water facilities) have separate and distinguishable process elements and are not the same when compared on a machine for machine basis, both types of facilities perform the same process of water intake, treatment and distribution by utilizing similar physical assets and equipment. Unlike *Malloof*, there is a “reasonable degree of continuity in the nature of the assets as well as in the general character of the business.” 65 T.C. at 271. Therefore, the planned water reclamation facility improvements as disclosed in Taxpayer’s submission will have closely similar physical characteristics to the improvements and equipment of the condemned City potable water facility.

b. Closely Similar End Uses.

In determining similarity of end uses of the condemned City potable water facility and the water reclamation facilities improvements end uses, the focus is on Taxpayer’s end use of each facility and the nature of Taxpayer’s relationship to both types of facilities. In this case, Taxpayer used the City potable water facility and continues to use the water reclamation facilities to gather, treat and distribute water to customers.

Further, management and control in regards to the City potable water facility and the water reclamation facilities were not only closely similar but integrated and shared for both types of facilities. Additionally, both types of facilities are subject to the same regulatory governance.

Thus, the proposed replacement in the present case is distinguishable from situations where the taxpayer’s end use of its property or relationship to the property changes. This case is not analogous to the situation described in Rev. Rul. 64-237, in which the taxpayer’s business changed from a manufacturing plant to a wholesale grocery warehouse. Neither is Taxpayer’s replacement akin to switching from an import-export business to a manufacturing concern as in *Malloof*. Rather, the end uses of both the condemned and the replacement properties – the intake, treatment and distribution of potable and reclaimed waters to customers – not only appear closely similar, but are components of the same integrated business.

RULING

The water reclamation facility improvements as described in Taxpayer’s submission are similar or related in service or use to the condemned City potable water facility for purposes of § 1033 of the Code.

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
Office of Chief Counsel  
(Income Tax & Accounting)

cc: